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# In the Supreme Court of the United States

OCTOBER TERM, 1951

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No. 152

S. KLEIN ON THE SQUARE, INC., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The opinion of the Court of Appeals (R. 227-231) is reported at 188 F. 2d 127. The opinion of the Tax Court (R. 31-40) is reported at 14 T. C. 786.

### JURISDICTION

The judgment of the Court of Appeals was entered on April 4, 1951. (R. 231-232.) The petition for a writ of certiorari was filed on June 28, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

### QUESTION PRESENTED

Whether in the computation of the excess profits tax credit on the income method taxpayer is entitled to the base period experience of a decedent, S. Klein, who operated the business as sole proprietor during the base period years and until his death in 1942. The answer to this question, under Section 742, Internal Revenue Code, turns on (1) whether the taxpayer acquired its assets in an exchange to which Section 112(b)(5) was applicable as required by Section 740(a)(1)(D), and (2) if so, whether the decedent was a "component corporation" within the meaning of Section 740(b)(5).

### STATUTE AND REGULATIONS INVOLVED

The pertinent parts of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 11-19.

### STATEMENT

The facts were stipulated (R. 60-196), and may be summarized as follows:

Taxpayer is the corporate successor to a clothing and ready-to-wear business at 14 Union Square, New York City, operated by its founder, Samuel Klein, as sole proprietor until his death on November 15, 1942. In his will he directed his executors to incorporate the store and perpetuate his name. The store was part of the residue of the estate, which went into a trust fund whose beneficiaries were Klein's three daughters, four sisters

and his three brothers. The will also contained a provision that the executors could not sell the property unless a majority of the adult income beneficiaries gave their approval in writing. This requirement became a stumbling block when the executors and Klein's family disagreed on the terms of incorporation. Accordingly, in 1943 the executors petitioned the Surrogate of New York County for authority to proceed without such approval, and to disregard the direction for incorporation of the business. The authority was granted on March 3, 1944. (R. 31-32, 61, 97-106.)

On April 3, 1944, Klein's son-in-law, Herbert D. Stone, representing the family, agreed with the members of the family he was representing to try to raise $1,000,000 to buy the stock in the anticipated corporation. An offer was made by the Stone group to buy all of the stock of a corporation to be organized by the executors. The Surrogate ordered that the business be sold in accordance with that offer. On April 5, 1944, Klein's executors executed a certificate of incorporation for the taxpayer and the following day (April 6) filed it with the Secretary of the State of New York. On the latter date the executors and Stone agreed on the proposal previously approved by the Surrogate's Court. By this the parties to the April 3 agreement, acting through Stone, were to pay $1,000,000 for the stock of the new corporation: $100,000 which had been paid at the time of the offer in the Surrogate's Court, $100,000 at the time

of the April 6 agreement, and $800,000 on or before April 11, 1944. The executors agreed to deliver to Stone 4,000 shares of Class A stock, endorsed in blank, immediately upon the closing of the transaction. (R. 32-33, 62, 122-185.) On April 15, the executors and taxpayer's directors in substance exchanged the store's assets for all the stock in the corporation, of which there were several classes. The record does not show whether or not the $800,000 was actually paid but the Tax Court stated that it "apparently" was (R. 34) and the Court of Appeals so assumed (R. 228-229). In any event, the executors voted the stock on April 15 to elect members of the Stone syndicate as the directors and officers of taxpayer. (R. 165-166, 210-211, 216.) The executors continued to hold the stock issued to them, but subsequently endorsed it in blank, until October 10, 1944, when new certificates were issued either to the persons or to the nominees of persons who were represented by Stone. (R. 33-34.)

In determining the deficiencies the Commissioner computed the excess profits net income for both periods involved (April 16, 1944, to September 30, 1944, and fiscal year ended September 30, 1945) on the invested capital method, explaining that the taxpayer did not qualify as an acquiring corporation within the meaning of Section 740 and, therefore, was not entitled to have its excess profits computed on the income method. (R. 34-35.) The Tax Court, in a reviewed decision from which no judge dissented, approved the Commissioner's de-

termination. (R. 31-40.) The Court of Appeals affirmed. (R. 231.)

ARGUMENT

1. Section 742 of the Internal Revenue Code (Appendix, *infra*, pp. 13-14) permits an "acquiring corporation" to use the base period income experience of its "component" corporations for the purpose of computing the excess profits tax credit on the income method under Section 713. Both courts below held that the transfer of the assets used in the business of the decedent by his executors to taxpayer—organized by them in return for all of the stock which, under a pre-existing contract and order of the Surrogate's Court, was required to be sold to certain of decedent's devisees and relatives—did not meet the control requirements of Code Section 112(b)(5) (Appendix, *infra*, p. 11). Under the provision of Section 740(a)(1)(D) (Appendix, *infra*, p. 12), upon which taxpayer relies, compliance with Section 112(b)(5) is required before taxpayer can be considered an "acquiring corporation."

This holding is unquestionably correct because the sole purpose of incorporating the taxpayer, as both courts below viewed the stipulated facts, was to give control of the S. Klein assets to the members of the Stone syndicate. The circumstance that the stock was temporarily in the physical custody of the executor-transferors does not satisfy the continuity of interest requirement which is the underlying assumption of both Section 740(a)(1)

(D) and Section 112(b)(5), as is made plain by the statutory language and the Regulations,[1] because, as we have emphasized, it cannot be disputed that the purpose of the transfer was not to perpetuate the executor's control but to effect a sale of the business, the antithesis of the situation contemplated by the statute. The holding that under these circumstances the transferors were not "immediately after the exchange * * * in control of the corporation" as required by Section 112(b)(5) is in accord with all of the decided cases. *Bassick* v. *Commissioner*, 85 F. 2d 8 (C.A. 2), certiorari denied, 299 U.S. 592; *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. 2d 77 (C.A. 10); *Hazeltine Corp.* v. *Commissioner*, 89 F. 2d 513 (C.A. 3); *Halliburton* v. *Commissioner*, 78 F. 2d 265, 267 (C.A. 9). Cf. *Ahles Realty Corp.* v. *Commissioner*, 71 F. 2d 150 (C.A. 2), certiorari denied, 293 U. S. 611.

Taxpayer bases its petition for certiorari, on the

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[1] Section 35.740-2(b), Treasury Regulations 112 (Appendix, *infra*, pp. 18-19), states that since Supplement A of the Code (Sections 740 and 742) applies only to cases where there is a sufficient continuity of interest to justify treating a corporation which has acquired the assets of a partnership or sole proprietorship as standing in the place of its predecessor, "such transactions must satisfy all the requirements of the regulations prescribed under section 112 * * *." And Section 29.112(b)(5)-1, Treasury Regulations 111 (Appendix, *infra*, pp. 15-16), interpreting Code Section 112(b)(5), states:

> The phrase "immediately after the exchange" * * * comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Section 112(b)(5) issue, solely on the contention (Pet. 5) that the decision below is in conflict with *American Bantam Car Co.* v. *Commissioner,* 177 F. 2d 513 (C.A. 3). The contention is without foundation. In that case the transferors did not enter into a prior binding contract to transfer their stock in the transferee to third parties as was done here, but, on the contrary, entered into a highly contingent agreement to do so only after the transferors were in control of a new corporation. The opinion of the Tax Court (*American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 406), which was affirmed *per curiam* by the Court of Appeals, itself distinguished the *Hazeltine* and *Bassick* cases cited, *supra,* on the grounds that in *American Bantam* "there was no written contract prior to the exchange" and "the underwriters received no absolute right to ownership of the common stock, but only when, as, and if, certain percentages of preferred stock were sold." The court further pointed out (p. 406): "How clearly contingent was the nature of their rights is illustrated by the fact that only one underwriter, Grant, met the terms of the agreement and became entitled to any shares."

Taxpayer attempts (Br. 10-14) to bring this case within the rationale of the *American Bantam* case by suggesting that the incorporation of the taxpayer would have proceeded independently of the contract with the Stone group. This argument is premised on a state of facts contrary to those

stipulated, as viewed by both courts below, and does not merit serious consideration.

2. In an alternative holding the Tax Court concluded (R. 38-40) that even if the transfer to taxpayer by the executors had met the requirements of Section 112(b)(5), taxpayer would nevertheless not have been entitled to the base period experience it sought to utilize, because the transfer had been made by the executors who had no such experience to transmit. In the statutory terminology the holding was that compliance with Section 112(b)(5) would have at best made the executors, and not the decedent, a component corporation of taxpayer under Section 740(a)(1)(D) and (b)(5). The Court of Appeals did not reach this issue but indicated (R. 230-231) that had the question been squarely before it it would have agreed with the Tax Court.

In this posture of the case, the alternative issue affords no basis for the issuance of the writ of certiorari, as urged by taxpayer, because there is no need to resolve that issue unless there should be a determination adverse to the Commissioner on the Section 112(b)(5) question.[2] In any event, there is no substance to taxpayer's argument on the merits of the issue, no reasonable support therefor being found in the language of Section 740. Cf. *E. T. Renfro Drug Co.* v. *Commissioner*, 183 F. 2d 846 (C. A. 5), certiorari denied, 340 U. S.

[2] Admittedly, the point is one of first impression (Pet. 5-6), and there is, of course, no question of a conflict.

930. Taxpayer rests its contention principally (Br. 14-16) on the unsupported assertion that the purpose of Supplement A was to grant all corporations the benefit of the income experience of any predecessor business. The argument thus advanced ignores the fact, clearly attested by the language of Supplement A, Appendix, *infra,* pp. 12-14, that a taxpayer who, as a matter of right, is entitled under the statute to utilize the base period experience of a predecessor must not only operate substantially the same business as the predecessor, but in addition, the ownership of the business must be essentially the same.

Taxpayer's contention that the Commissioner's position (Br. 17) "would defeat the use of the best available method of determining normal earnings" overlooks the controlling consideration that under the congressional policy as expressed in Supplement A the present owners of the business did not create the income experience of the base period and therefore should not be allowed to use it. It is plain that adoption of taxpayer's policy would result in the artificial and unrealistic standard of measuring its excessive profits by the experience of a stranger in operating that business.

Taxpayer's further contention (Br. 19-20) that there is "analogous precedent" under the Code for recognition of the continuity of the decedent and his estate proves too much because Supplement A, unlike the other provisions relied upon by taxpayer, provides no such identity, and in any

event, generally the Code treats decedents and their estates as separate taxpayers. Internal Revenue Code, Subchapter C—Supplement E; see, for example, *Estate of Putnam* v. *Commissioner*, 324 U. S. 393; *Helvering* v. *Enright*, 312 U. S. 636.

### CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1951.

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APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * *

* * * * *

(h) *Definition of Control.*—As used in this section the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * *

(26 U.S.C. 1946 ed., Sec. 112.)

PART II—Rules in Connection With Certain Exchanges [As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]

Supplement A—Excess Profits Credit Based on Income

SEC. 740. DEFINITIONS.

For the purposes of this Supplement—

(a) *Acquiring Corporation.*—The term "acquiring corporation" means—

(1) A corporation which has acquired—

* * * * *

(D) [Added by Sec. 8(a) of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17.] Substantially all the properties of a partnership in an exchange to which section 112 (b) (5), or so much of section 112 (c) or (e) as refers to section 112 (b) (5), or to which a corresponding provision of a prior revenue law, is or was applicable.

* * * * *

(b) *Component Corporation.*—The term "component corporation" means—

* * * * *

(5) [Added by Sec. 8(b) of the Excess Profits Tax Amendments of 1941, *supra.*] In the case of a transaction specified in subsection (a) (1) (D), the partnership whose properties were acquired.

* * * * *

(g) [Amended by Sec. 228(a) of the Revenue Act of 1942, c. 619, 56 Stat 798] *Component Corporations of Component Corporations.*—If a corporation is a component corporation of an acquiring corporation, under

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subsection (b) or under this subsection, it shall (except for the purposes of section 742 (d) (1) and (2) and section 743 (a) (1), (2), and (3)) also be a component corporation of the corporation of which such acquiring corporation is a component corporation.

(h) [Added by Sec. 8(c) of the Excess Profits Tax Amendments of 1941, *supra*] *Sole Proprietorship.*—For the purposes of sections 740 (a) (1) (D), 740 (b) (5), and 742 (g), a business owned by a sole proprietorship shall be considered a partnership.

(26 U.S.C. 1946 ed., Sec. 740.)

SEC. 742 [as amended by Section 228 (c) of the Revenue Act of 1942, *supra*]. SUPPLEMENT A AVERAGE BASE PERIOD NET INCOME.

In the case of a taxpayer which is an acquiring corporation, its average base period net income (for the purpose of the credit computed under section 713) shall be the amount computed under section 713 or the amount of its Supplement A average base period net income, whichever is the greater. The Supplement A average base period net income shall be the amount computed without regard to subsection (h) of this section or computed under subsection (h) of this section, whichever is the greater. The Supplement A average base period net income shall be computed as follows:

* * * * *

(g) In the case of a partnership which is a component corporation by virtue of section 740 (b) (5), the computations required by this

Supplement shall be made, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, as if such partnership had been a corporation. For the purpose of such computations, in making the adjustment for income taxes required by section 711 (b) (1) (A), the partnership so regarded as a corporation shall be considered as having distributed all its net income as a dividend.

* * * * *

(26 U. S. C. 1946 ed., Sec. 742.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.112(a)-1. *Sales or Exchanges.*—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112(b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property * * * The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

* * * * *

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112(b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

* * * * *

SEC. 29.112 (b) (5)-1. *Transfer of Property to Corporation Controlled by Transferor.* —As used in section 112(b)(5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 3797); and to be in "control" of the transferee corporation such person or persons must own immediately after

the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. (See section 112(h).) The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

* * * * *

*Example (3).* B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1942. He transfers the property to the N Corporation in 1942 for 78 percent of each class of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112(h).)

* * * * *

SEC. 29.112(h)-1. *Control of Corporation.* —Section 112(h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112(b)(5) and section 112(g)(1). It is provided specifically that this definition is limited to the meaning of the term "control" as that term is used in section 112.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.740-1. *Purpose and Scope of Supplement A.*—(a) The term "Supplement A," when used in these regulations, means sections 740 and 742 to 744. Supplement A provides rules governing the right to use the excess profits credit based on income and the method of computing such credit, in the case of certain "acquiring" corporations. An acquiring corporation is a domestic corporation which has absorbed one or more other domestic corporations, partnerships, or businesses owned by sole proprietorships in a transaction meeting the requirements set forth in section 740(a), which transaction is generally referred to in these regulations as a "Supplement A transaction." Each such absorbed corporation, partnership, or business owned by a sole proprietorship is designated a component corporation of the acquiring corporation. Furthermore, except for the purposes of section 742 (d) (1) and (2) and section 743(a) (1), (2), and (3), if an acquiring corporation is later absorbed by another acquiring corporation, all of the component corporations of the first acquiring corporation become component corporations of the second acquiring corporation. * * *

(b) The purpose of Supplement A is in general to attribute to an acquiring corporation the existence of corporations, partnerships, or businesses owned by sole proprietorships absorbed by it, together with the base period excess profits net income or deficit in excess

profits net income and the net capital changes of such predecessors, in order (1) that a corporation the corporate life of which in substance, though not in form, includes the base period may use the excess profits credit based on income and (2) that a corporation composed in whole or in part of component corporations may compute its excess profits credit in the light of the base period experience of the entire enterprise. * * *

SEC. 35.740-2. *Transactions Whereby a Corporation Becomes an Acquiring Corporation.*—(a) The types of transactions whereby a corporation can become an acquiring corporation are specifically described in section 740(a). In addition to statutory mergers and consolidations and the acquisition of property in a complete liquidation in which gain or loss is not recognized because of the provisions of section 112(b)(6) or the same section as contained in the Revenue Act of 1936 or 1938, only the following types of transactions are included:

* * * * *

(4) The acquisition of substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112(c) or (e) as refers to section 112(b)(5), or to which the corresponding provisions of a prior revenue law, is or was applicable. For the purposes of this paragraph a business owned by a sole proprietorship shall be considered a partnership.

(b) The types of transactions set forth in section 740(a), other than those set forth in

section 740(a)(1)(C), either are embraced within the definition of a reorganization contained in section 112(g)(1), are transfers to a controlled corporation within the meaning of section 112(b)(5) and related sections, or are complete liquidations within the meaning of section 112(b) (6). Since Supplement A applies only to cases where there is a sufficient continuity of interest to justify treating a corporation by which the assets of another corporation, a partnership, or a business owned by a sole proprietorship have been acquired, as standing in the place of its predecessor, such transactions must satisfy all the requirements of the regulations prescribed under section 112 with respect to such transactions in order that the transferee corporation may be treated as an acquiring corporation.

* * * * *

SEC. 35.740-4. *Partnerships and Sole Proprietorships Under Supplement A.*—A partnership (or a business owned by a sole proprietorship) can be a component corporation for the purposes of Supplement A, subject to the exceptions in section 740(g). However, a partnership (or a business owned by a sole proprietorship) cannot be an acquiring corporation and, therefore, section 740 (g) cannot operate to make any of its predecessors component corporations of its acquiring corporation.

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